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Minutes #451

Minutes of the Board of Trustees' Meeting -1-

Call to Order: Chairman, Donald Pinard called the meeting to order at 8:33 a.m.

Present: Trustees: Chairman, Donald Pinard, Jennie Angell, Richard Molan, Chuck Hungler, William Sanders and Kevin Barry arrived at 8:35 a.m.
MECRS Staff: Gerard Fleury, Sandi Aboshar and Suzanne Wilson

Absent: Trustees: Mayor Frank Guinta

In Attendance: Attorney John Rich of McLane Law Firm
Mr. Kevin Leonard and Mr. Sebastian Grzejka of NEPC
Mr. Magid of Audax Group (via conference call)
Mr. Masiello of Newstone Capital
Mr. John Rocchio (via conference call) Newstone Capital
Mr. David Petrucco, Mr. Edward Cerny, and Mr. Terry Quinn, all of Kayne Anderson Mezzanine Partners

Approval of the Minutes of the Previous Board Meeting:

A motion was made by Trustee Angell to approve the minutes of the August 8, 2009 board meeting, seconded by Trustee Hungler and passed unanimously by all those trustees present.

Approval of the Immediate Meeting Agenda:

Trustee Sanders made a motion to accept the immediate meeting agenda, seconded by Trustee Angell and passed unanimously by all those trustees present.

Report of the Executive Director:

Update – Request From a Vested Deferred Member - Mr. Fleury reported that at last month's meeting of the Board of Trustees, that a vested deferred member had expressed interest in the System's Additional Contribution Program and that he had referred the eligibility question to counsel before proceeding.

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Mr. Fleury informed the board that at this time he has not received a response from counsel therefore the matter will carry forward to the October board meeting.

7th Annual NEPERS Conference – Next, Mr. Fleury reported that he has been invited to participate on a panel at the 7th Annual NEPERS Conference in Boston on October 27th. MECRS's trustees are also invited to attend the conference and the System will not incur expenses for their registration.

Mr. Fleury respectfully requested the board's permission to attend the conference on October 27th.

The trustees unanimously agreed to grant Mr. Fleury's request to attend the NEPERS Conference.

Experience Study With GRS - Moving on, Mr. Fleury noted that at the August board meeting, the trustees authorized an experience study by Gabriel, Roeder, Smith & Co. subjected to a negotiated price to keep the engagement within budget limits. The requirement was communicated to GRS and they agreed to cut \$1,000 from the quote they had submitted for the job which brought the total price within the budget ceiling. As a result an agreement was signed on August 25th and the study will begin soon.

New Internal Control Added - Mr. Fleury informed the board that while processing manager invoices for the second quarter of 2009, it was discovered that an invoice from Prudential, for the first quarter, had not been processed due to extenuating circumstances. This came to light when the vendor included the first quarter fee as "past due" on the subsequent invoice. To prevent any repetition of this type of problem, a payment tracking control instituted a few years ago was expanded to ensure that invoices which are anticipated will be sought out and processed when they are not received within the expected timeframe. Mr. Fleury credited Trustee Hungler for having been the catalyst for the discovery of this problem and he complemented Mr. Hungler's acute instinct for detecting accounting issues.

Investment Options for Cash Reserves - Mr. Fleury reported that in response to the board's request a month earlier, he had explored options on cash investment returns due to concerns about the low yield on cash balances with State Street Bank and Trust Co. He noted that he has requested information from State Street on cash management option but has yet to receive it. In shopping around locally,

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Mr. Fleury confirmed that he has received proposal from TD Bank North and Citizens Bank. He explained that after he has received all of the requested information and had an opportunity to review and compare those proposals, the board would be given a full report of his findings. Mr. Fleury expects that his report might be as soon as the October board meeting.

Trustee Sanders expressed a desire to review those proposals as well and Mr. Fleury responded that he would be happy to forward copies to his office.

Status Report of Pension Software Upgrade- Mr. Fleury explained that for some time MECRS had been contemplating updating the pension information system. The firm that produces the software currently in use by the System, no longer sells the product in that format and will eventually discontinue support for the product which is the primary incentive for investigating an upgrade. Mr. Fleury reminded the Board that the firm had made an offer to upgrade the MECRS System, about a year ago, to the current release which employs a methodology toward customization of business rules which is more up to date than the hard coded versions presently used by MECRS. In exploring the MECRS's options, Mr. Fleury went on to report that he had written to a number of other public plans that were using the new software. The responses he received were not too encouraging so as a follow up, this month Mr. Fleury and his Executive Assistant, Ms. Aboshar had visited the Taunton Massachusetts Retirement System which has had the upgraded package for about a year. During their visit, the MECRS team found that Taunton was still not using the upgrade in its entirety and still had a number of reservations about the product.

In light of his findings, Mr. Fleury went on to explain that he will be drafting a contract with certain guarantees, including a set of circumstances, where the vendor will have to provide a migration tool so that the System can transfer data from the existing system to the new system on demand and at no additional cost in order to facilitate restarts of regression testing and parallel testing on the upgrades should the kinds of difficulties experience by other retirement systems happen at MECRS. Mr. Fleury also wants to insist on absolute satisfaction with the upgrade before payments to the vendor are made. When the System converts to the upgrade, all program requirements are met, and identical results are produced between the existing system and the upgrade version, the vendor would be paid in full. In that way, the risk would be entirely on the vendor. Mr. Fleury believes if the vendor is as capable as they are confident, that they should be willing to accept that risk and if they won't, then MECRS should seek alternate vendors.

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Board Elections Are Upcoming - Mr. Fleury reminded the trustees that the board election is coming up at the end of the year for citizen's representative and that initial step for the election are already underway. Retirees will be receiving a notice regarding the election details on October 1st and the announcement will also be placed on the System's web site. The notice informs individuals who are interested in running for election/re-election about the process and its time requirements. In addition, an ad will also be placed in the Manchester Union Leader as well as a posted at Manchester City Hall and the Manchester Public Library.

Referring back to the pension system upgrade proposals received from Tyler Technologies, Trustee Angell asked if she would also be able to review the proposals and cited her experience in negotiating contracts for the Information Systems Department.

Mr. Fleury welcomed her interest and agreed to provide her with copies of all materials on the subject.

In closing his report, Mr. Fleury expressed his desire to bring the MECRS budget for 2010 to the board in November. This would allow time to review and adjust any line items before December and to have an approved budget in place for the start of the next budget year. The Administration and Accounting Committee which received the draft budget first, can therefore expect to see that draft at an October meeting. Mr. Fleury did not expect much of a change in the budget and so an initial review of the preliminary numbers should not be too time consuming.

With that being said Administration and Accounting Committee, Chairman Barry, scheduled the next A & A meeting to be held at 8:00 am, just prior to the next meeting of the full MECRS Board on October 13, 2009. The agenda would be limited to receipt of the draft MECRS budget for 2010 and any budget related issues.

Trustee Hungler referred to the financial statements, item #C-4, Cash in the amount of \$5,807,900.40 and asked why that amount does not match the amount on the cash flow projection schedule prepared by Mr. Fleury.

Mr. Fleury explained that the cash flow projection schedule is designed to reflect cash available for investment purposes but that not all cash accounts fit that criterion. He provided an example, stating that the MECRS administrative salaries are paid from an account at the Members First Credit Union. When reporting

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“Cash” on the financial statements, all accounts including cash at Members First is summarized into one line on the balance sheet. The bottom line reflected on the cash flow projection schedule is limited to the balance at State Street Bank in MECRS account 2BY3. Trustee Hungler thanked Mr. Fleury for his explanation.

Consent Agenda:

Prior to voting on the Consent Agenda, Chairman Pinard asked the trustees if anybody wished to remove any item for discussion. Trustee Hungler responded and removed Consent Item #C3. It was then moved by Trustee Hungler to approve the remaining Consent Agenda, seconded by Trustee Sanders and passed unanimously by all those trustees present.

Regarding Consent Item #3, Pension Payroll, Trustee Hungler inquired why the first member listed under Adjustments/Additions is scheduled to experience a large adjustment.

Ms. Aboshar explained that the member in question is a vested deferred member who had received a retroactive first payment. The nature of the adjustment was therefore to set the amount of subsequent payments to the normal monthly amount.

Trustee Hungler then moved to accept Consent Agenda Item #C3, seconded by Trustee Molan and passed unanimously by all those trustees present.

New Business:

Presentations of Mezzanine Managers – Mr. Kevin Leonard and Mr. Sebastian Grzejka of NEPC were in attendance to coordinate/oversee the Mezzanine Private Equity Manager presentations and the potential commitment of \$1.5 million into a mezzanine fund.

Mr. Fleury placed a conference call to Audax Group, in New York in order to facilitate the interview of Mr. Kevin Magid, Managing Director of the Mezzanine Investment Team at Audax Group. Mr. Magid introduced himself followed by Mr. Fleury's introduction of the Board of Trustees, the System's legal counsel and staff members in attendance.

Mr. Magid thanked the board for the opportunity to address them and provided a brief bio of his tenure with Audax stating that he was the founder of the debt business at Audax, specifically the mezzanine business, which began 10 years ago.

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Presentation booklets had been shipped in anticipation of the interviews and included in the trustee's monthly board packets. Mr. Magid referred to page 4 of the Audax presentation booklet which provided an overview of 110 professionals associated with the group and also the history behind the firm.

Mr. Magid pointed out the reasons why the MECRS Trustees should be interested in the Audax mezzanine product, such as recognized market leadership, a proven and cohesive team, disciplined lending approach, diverse transaction sources and superior investment performance on realized transactions.

Mr. Magid referred to the investment strategy which he noted as having a middle market focus and an average investment size of \$20 million. He stated that the Audax firm covers over 190 equity sponsor relationships and 80% of deal flow is sourced directly from Audax. He also spoke about capital preservation and attractive returns.

While MECRS will be considering participation in the upcoming Fund III, for illustrative purposes Mr. Magid summarized Fund I and Fund II Portfolios reviewing fund details, transaction metrics and portfolio construction. He noted that Audax began investing in Fund II in July 2006.

Mr. Magid explained a chart on Audax's significant deal sourcing capability, noting the history since 2001 up through the June 2009, consistently increasing the number of deals per month. Year to date 2009, Audax has generated 28 deals per month.

Mr. Leonard of NEPC asked Mr. Magid to review the deal terms of Fund III, in order to possibly stimulate questions from the trustees.

Mr. Magid briefed the trustees on the terms of the fund noting its consistency with Funds I and Fund II.

Trustee Hungler asked Mr. Magid if Audax currently has other public pension funds that have invested in Fund I or II.

Mr. Magid responded, absolutely, the largest public pension fund in the U.S., CALPERS, is in both Funds I and II with over \$100 million invested.

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Furthermore, the State of New Jersey Pension, City of Boston, State of NH and the City of Philadelphia have recently made commitments to Fund III.

Mr. Fleury asked Mr. Magid, if Audax allows side letter agreements such as the Most Favored Nations Status and if that was something that Audax would feel comfortable doing with MECRS if it were to consider investing with them.

Mr. Magid responded that there would be no problem, and that they recognized there are certain needs by certain investors.

Mr. Fleury then asked about unilateral changes to the limited partnership agreement after a closure period and if Audax would have difficulty with a provision within the contract that states that the investor would have to be notified in writing of any changes inclusive of liquidity issues.

Mr Magid replied that all investors receive changes to any partnership agreement.

Mr. Magid having concluded his presentation and there being no further question at the MECRS ending of the call, Mr. Fleury thanked Mr. Magid for his presentation and ended the conference call.

The board recessed the meeting at 10:07 a.m.

The board convened the meeting at 10:14 a.m.

NEPC representatives escorted Mr. Steven Masiello of Client Services, Newstone Capital Partners into the room while Mr. Fleury established a conference call link with Mr. John C. Rocchio. Next, Mr. Fleury introduced himself and the Board of Trustees to Mr. Masiello and to Mr. Rocchio, Co-Founder and Managing Director of Newstone who was now joined via conference call.

Mr Rocchio began his presentation explaining that Newstone Capital is established as an independent and entrepreneurial firm focused solely on providing mezzanine capital to private equity sponsors. Newstone is targeting \$900 million of capital commitments for Newstone Capital Partners II, LP.

Mr. Rocchio listed 3 differentiating factors which he thought distinguished Newstone Capital. One is the experience, two is relationships and the third is performance generated over the past thirteen years.

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Mr. Rocchio also noted that he and co-founder, Tim Costello have been investing together in mezzanines for the past 15 years and have assembled a team of highly qualified experienced individuals. He also mentioned that they have a proven strategy, discipline and philosophy which they have consistently followed since 1995.

Working from presentation materials which had been provided in advance, Mr. Rocchio provided an overview of the mezzanine investment team. He cited twelve associates dedicated to this investment strategy, all coming with a wealth of experience. Ten of the associates are on the investing side while two associates handle financial and performance reporting.

Moving on to strategy within Newstone, Mr. Rocchio stated that their goal is to create a diversified portfolio of mezzanine investments, invest with leading private equity sponsors, target larger middle-market issuers and focus on principal preservation. The average EBITA (Earnings Before Income Tax Depreciation and Amortization) is about \$55 million and so Newstone looks at companies in size and scale that have less risk to them. Mezzanine adds financial risk and so Newstone looks for companies with less operating risk. Newstone believes the larger companies with more diversified customers, more diversified products, operating more diversified markets will mitigate that risk and increase the chance in probability of success.

Mr. Rocchio stated that Newstone has extensive relationships with lending private equity firms and intermediaries. Newstone has completed transactions with over 40 private equity firms and has had multiple transactions with numerous sponsors. He then reviewed a list of private equity sponsors that have investments in Newstone.

Continuing, Mr. Rocchio noted that Newstone has no conflicting loyalties, for example, they have no competing private equity fund, no competing distressed debt fund and no internal strategy conflicts.

With respect to performance, Mr. Rocchio stated that Newstone has successfully invested through various economic and financial market cycles, generated composite net returns of 17.8% and a 1.7 times multiple of investment capital since 1996, while creating over \$2 billion of gains for investors.

Mr. Rocchio reviewed different charts within the presentation booklets regarding the investment environment, such as changing mix, investment pace, competitive landscape and tightening credit standards.

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Mr. Rocchio then briefed the trustees on Newstone's Investment Portfolio, Fund I stating that they have invested \$744 million in nineteen transactions with leading private equity firms, generated over \$75 million annually in portfolio income, realized 28% of invested capital and the average equity capital exceeds 36%.

Mr. Rocchio summarized his presentation, noting a proven investment team, continuity of strategy, discipline and philosophy, compelling market conditions, excellent source of deal flow, top quartile track record as well as favorable partnership terms.

Having concluded his presentation, Mr. Rocchio entertained questions from the trustees.

Mr. Fleury asked Mr. Rocchio, if in the contract agreement, would Newstone have any difficulty extending the Most Favored Nations Status to an investor as small as MECRS.

Mr. Rocchio replied that every investor of Newstone gets Most Favored Nations Status. All investors are treated the same.

Mr. Fleury cited another contract issue of concern to MECRS wherein some investment limited partnerships in the past year had changed the terms of the partnership and restricted or rescinded withdrawal terms which they had allowed at subscription time. Such changes had been made either unilaterally or by majority vote of the limited partners but without recourse in the event that the changes were opposed by the limited partner. While all of the changes observed had been deemed advantageous to MECRS as an investor, there are no guarantees that any future changes would be so favorable. MECRS is therefore seeking a contractual guarantee that if the terms of the original agreement were to be amended in any way that MECRS would have to be notified in advanced and would have to agree to such a change.

Mr. Rocchio replied that Newstone has never been in that situation. Any type of change to contractual terms would require unanimous consent.

Attorney John Rich questioned Mr. Rocchio's earlier comment about operating in the larger middle market. Attorney Rich asked, is there something inherent in the mezzanine business that would prevent an investor from operating in the lower middle market from doing as good a job? Also, Attorney Rich noted that the trustees are also considering firms that are a little downstream than Newstone. What makes a larger middle market a great place to be, Attorney Rich inquired?

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Mr. Rocchio replied that Newstone believes that the smaller companies have more of an operating risk which is less inherent in larger middle market companies.

The trustees continued to ask Mr. Rocchio questions regarding their disclosure policies, contractual limitations, capital calls and exit strategies which he answered in turn.

Having concluded his presentation and there being no further questions of Mr. Rocchio, he thanked the trustees for their time and ended the conference call.

Mr. Masiello summarized the presentation by reiterating Mr. Rocchio comments on the predecessor funds and the difference between small cap and mid cap funds in the mezzanine asset class in terms of risk and preservation of capital.

There being no further questions of Mr. Masiello, he thanked the Board again and departed at 11:14 a.m.

At 11:15 a.m. Chairman Pinard entertained a motion to extend the meeting beyond the 3 hour limitation, pursuant to Article XIII of the MECRS By-Laws. It was moved by Trustee Sanders to extend the meeting, seconded by Trustee Hungler and passed unanimously by all those trustees in attendance.

NEPC representatives then escorted members of the Kayne Anderson team into the meeting. Following brief introductions Mr. Terry Quinn, Senior Managing Director began with a brief overview of Kayne Anderson stating that the firm is Los Angeles based with a large presence in New York and Houston. Kayne Anderson is an independent investment firm with a 25-year history and a focus on alternative investment strategies. At the end of his brief introduction to the firm, he then turned the presentation over to his colleagues Mr. David Petrucco and Mr. Edward Cerny, Co-Managing Partners.

Mr. Petrucco explained that Kayne Anderson is a \$500 million US middle market mezzanine fund. Kayne had a preliminary closing with over \$70 million of commitments in May of 2009, had begun operations and two completed transactions. Mr. Petrucco explained Kayne Anderson's plan to expand their successful initial May closing by including new investors. He elaborated on their middle market investing platform, their consistent investment philosophy, and their focus on "return of capital" before "return on capital".

Mr. Petrucco went on to explain that mezzanine is a transparent business that provides liquidity and that Kayne Anderson makes loans to established, cash

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generating businesses. They focus on companies with dominant or defensible market positions and that interest is typically paid quarterly. All income accrues to the Fund.

Mr. Cerny detailed the way in which Kayne Anderson provides service to their investors and on the amount of time taken with mezzanine investments. He then referred to page 14 of their presentation booklet, which had been included in the trustee's agenda packets and reviewed a list of private equity sponsor and financial intermediary relationships which they have fostered.

Mr. Petrucco expressed his belief that the markets that have been most susceptible to the irrational exuberance of the last few years were not the middle markets.

Mr. Leonard asked Mr. Petrucco to explain the terms of the fund.

Mr. Petrucco and Mr. Cerny worked in concert to summarize the key terms of the limited partnership agreement. They further explained that Kayne is targeting a commitment size of \$2 million with an investment period of 5 years from the initial close. Initial management fees are 1.75% annually based upon commitments during the investment period, thereafter the fee becomes 1.50% of the lower of the cost or the fair market value of investments.

Mr. Fleury asked the Kayne Management Team how they felt about a Most Favored Nations Status being included in the subscription agreement.

Mr. Cerny replied that Most Favored Nations Status is a standard document within their firm.

The Kayne Anderson representatives having completed their presentation and there being no further question from the board, Chairman Pinard thanked the gentlemen for their presentation and they departed.

Chairman Pinard asked Mr. Leonard, to recap the nature of risk involved in mezzanine investments.

Mr. Leonard responded that mezzanine is the least risky aspect of private equity. Private equity is risky because it is a private marketplace. It is not publicly traded, or a regulated investment arena, like the stock market. It tends to be illiquid and its valuations are less precise than freely traded investments such as stocks and bonds. It is based essentially on the companies that the fund loans to.

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The trustees recapped the manager presentations and discussed the mezzanine asset class and the return expectation on mezzanine. Mr. Leonard noted that mezzanine is a strategic play but one with great opportunity.

After questioning the need to act immediately on the volume of information it had just received, the board elected to hold off on making any decision at this time.

There was recognition by the board that committing to this asset class would require one of two things; either MECRS would need to sit on more cash than was customary while it awaited funding requests from private equity managers or, committed cash would need to be parked in some other highly liquid asset class with minimum volatility to principal but yields superior to cash while awaiting the drawdown requests.

Mr. Kevin Leonard suggested requesting projected cash flow estimates for the next couple of years from any mezzanine manager that is selected by the trustees. The trustees continued to express concerns about the anemic return on cash currently being held to fund commitments to Secondary private equity investments made a year earlier.

Mr. Leonard suggested that funds could be allocated to core fixed income with the understanding of the manager that it would be liquidated and withdrawn on short notice.

Mr. Fleury reminded the board that he is currently waiting an additional proposal on cash management which might help to ease concerns about the opportunity cost associated with holding cash. He agreed to send Trustees Sanders and Angell copies of the proposals once he receives them.

In conclusion, it was decided that at next month's meeting, the board will be prepared to discuss how best to proceed and to determine the preferred options for cash investments and mezzanine investments.

Trustee Sanders moved to adjourn the meeting at 12:37 p.m., seconded by Trustee Pinard and passed unanimously by all those trustees present.

Respectfully Submitted,

Gerard E. Fleury
Executive Director